

No. 10556

IN THE
UNITED STATES
CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT

UNITED NATIONAL CORPORATION, a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR REVIEW FROM THE TAX COURT OF
THE UNITED STATES

BRIEF FOR THE PETITIONER

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FILED

NOV 5 - 1943

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OPINION BELOW

This case involves income tax for the fiscal year ended June 30, 1939, in the amount of \$3,224.86, as found by a decision of The Tax Court of the United States, entered June 15, 1943 (R. 43). Only part of the asserted deficiency is in controversy here. The case is brought to this court by a petition for review, filed August 16, 1943 (R. 43 to 47), pursuant to the provisions of sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED

When a corporation repurchases shares of its preferred stock for less than their par value and retires the shares, is the difference between the par value

and the repurchase price a part of its accumulated earnings or profits which would be taxable to the recipient if distributed under the circumstances set forth in 115(g) of the Internal Revenue Code?

STATEMENT OF THE CASE

The petitioner is a corporation, organized under the laws of the State of Washington, with its principal office in Seattle, Washington. It keeps its accounts and prepares its income tax returns on the accrual basis. The petitioner, within the time provided by law, filed with the Collector of Internal Revenue for the District of Washington, at Tacoma, Washington, its income tax return for the fiscal year ended June 30, 1939.

The petitioner accepts the findings of fact as made by The Tax Court of the United States (R. 19 to 29). Only a question of law is involved, based on the findings with respect to issue 2 (R. 28-29).

On September 6, 1938, the petitioner owned all of the outstanding 1,000 shares of common stock of Murphey, Favre & Co., a Washington corporation (hereinafter, for brevity, called Murphey) (R. 19). All of the preferred stock of Murphey had been retired prior to 1933 (R. 23). The petitioner desired to sell all of the shares of Murphey owned by it, but the purchasers did not have sufficient funds to purchase the entire block of stock. In order to make the sale, the charter of Murphey was amended in order to effect a reduction in the number of outstanding shares of stock from 1,000 shares of common stock to 250 shares of common stock. Upon the surrender

and cancellation of the 750 shares held by petitioner, there was distributed to petitioner, on or about September 6, 1938, 75% of the assets of Murphey, the amount so distributed being \$176,746.25. On September 16, 1938, petitioner sold the remaining 250 shares of common stock and Murphey continued in business (R. 23-24).

The Tax Court of the United States determined that, pursuant to section 115(g) of the Internal Revenue Code, the distribution received by petitioner was taxable to it, to the extent of the accumulated earnings or profits of Murphey as of the date of distribution. The petitioner does not appeal from this determination. The only question is: What was the amount of the accumulated earnings or profits as of the date of distribution? The petitioner contends that the amount of the accumulated earnings or profits was \$88,120.80, while the respondent contends that the correct figure is \$108,509.80 (the difference being \$20,389.00) (R. 29). The difference arises in this manner: On three occasions during the period from 1929 to 1932, Murphey repurchased its shares of preferred stock for retirement for a net sum of \$20,389.00 less than the par value of the shares so purchased. The shares were retired or cancelled. Murphey never traded in its own stock by buying from one customer and selling to another (R. 28).

NUMERICAL SPECIFICATION OF ERRORS RELIED UPON

1. (R. 49)

SUMMARY OF ARGUMENT

The Tax Court of the United States erroneously concluded that the sum of \$20,389, representing the net difference between the par value and the repurchase price by Murphey of shares of its preferred stock for retirement, was part of the accumulated earnings or profits of Murphey when a partial liquidation of Murphey took place by a reduction in its capital stock and the retirement of part of its outstanding shares.

ARGUMENT

Where a corporation repurchases its shares of preferred stock for less than the par value of the shares and retires the shares, the amount of the difference between the par value and the repurchase price is not a part of its earnings or profits.

Assignments of Error

The petitioner assigns as error the following acts and omissions of The Tax Court of the United States:

1. The determination by The Tax Court of the United States that the sum of \$20,389, representing the discount on the redemption of the preferred stock of Murphey, was a part of the accumulated earnings or profits of Murphey and that petitioner received taxable income in any amount greater than \$88,120.80 upon the partial liquidation of Murphey on the redemption of 750 shares of stock of Murphey held by petitioner.

The petitioner has acquiesced in the determination by The Tax Court of the United States in these proceedings that the distribution by Murphey to peti-

tioner, on the redemption of 750 shares of stock of Murphey held by petitioner, is taxable income to the petitioner, to the extent of the accumulated earnings or profits of Murphey. The only question left is: Was the amount of the difference between the par value of the shares of Murphey redeemed and the price paid by Murphey for the shares for redemption, a part of the accumulated earnings or profits of that corporation? The Tax Court of the United States held that it was. The petitioner contends that redemption was a capital transaction and had no effect on the accumulated earnings or profits.

Neither the Internal Revenue Code nor the Regulations contain an inclusive definition of the term Earnings or Profits. Reg. 103, Sec. 19.115-3 provides in part as follows:

“Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) or corresponding provisions of prior Revenue Acts.”

As has been said, the phrase must be given its ordinary and usual meaning. It is, however, clear that before a corporation can have earnings or profits, it must have had a gain.

Regulation 103, section 19.22(a)-16 provides as follows:

“ACQUISITION OR DISPOSITION BY A CORPORATION OF ITS OWN CAPITAL STOCK Whether the acquisition or disposition by a corporation of

shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock.

“But if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of the Internal Revenue Code.”

It should be kept in mind that The Tax Court of the United States in effect found that Murphey, Favre & Co. did not deal in its own shares as it would in the shares of another corporation. The lower court found as a fact that:

“The Murphey Co. never traded in its own stock by buying from one customer and selling to another. * * * Upon redemption, the shares were cancelled or retired.” (R. 28).

No case can be found holding that, when a corpora-

tion repurchases its shares, it realizes a gain. There is authority to the effect that if a corporation resells its shares for more than it paid for them, it realizes a profit, providing it is dealing in its shares as it might in the shares of another corporation.

If Murphey could not, under the above quoted Regulation, realize any gain or loss from the redemption of the preferred shares here in question, it is difficult to see how the transaction could increase its earnings or profits. The Tax Court of the United States, in its opinion, confused the point at issue with an entirely different point. The lower court fell into error by assuming that there was a gain to Murphey upon the repurchase of its preferred shares for retirement. That is the point at issue. It was stated in the opinion that there are many kinds of income which are not taxable income, yet would increase the earnings or profits. That this is true goes without saying; nevertheless, in such transactions, there is a gain — true, non-taxable because made specifically so by law, but, nonetheless, a gain. Here there was no gain upon the redemption of shares for less than par value. Murphey merely distributed some of its assets and reduced the number of its outstanding shares of preferred stock. The capital stock of a corporation is in no true sense a liability of the corporation. It is not a debt nor can payment be demanded.

“For bookkeeping purposes, the company acknowledges a liability in form to the stockholder equivalent to the aggregate par value of their stock, evidenced by a ‘Capital stock account’ * * * none of these, however, give to the stockholders

as a body, much less to any one of them, either a claim against the going concern for any particular sum of money, or a right to any particular portion of the assets or any share in them * * *”

Eisner v. Macomber, 252 U. S. 189, 40 S. Ct. 189, 64 L. ed. 521.

The par value of preferred shares denotes but very little as to the rights accruing to the shareholder in connection with the shares. The redemption price may be more or less than the par value. Suppose that, at the time the redemption occurred, Murphey had net assets of a worth less per share than the price paid for the preferred shares which it purchased. Could it be said that the corporation has added to its earnings or profits by the redemption of its shares? In such a case, the remaining shareholders would be worse off than before the redemption as their per share value would be less.

No gain accrues to a corporation upon the redemption of its shares of stock. It does not acquire anything; indeed, it has less assets after the redemption than it had before. See *E. R. Squibb & Sons v. Helvering* (C.C.A. 2) 98 F.(2d) 69, for an interesting discussion of the effect of the repurchase by a corporation of its own shares.

As was said in *Houston Brothers Co. v. Commissioner of Internal Revenue*, 21 B.T.A. 804:

“Before it can be said that a corporation has profit, it must be found not only that it has disposed of its property, but that it has received assets of greater value than the cost of those disposed of. But since a corporation’s own shares

are not assets, but only the convenient machinery for evidencing shareholders' interests, it is a fallacy to say it has received anything and, *a fortiori*, that it has received a gain."

In *Liberty Agency Co. v. Commissioner of Internal Revenue*, 5 B.T.A. 778, it was held that a corporation realized no gain on the redemption of its preferred shares, the opinion saying:

"We are of the opinion that the petitioner realized no taxable gain when it purchased its own preferred stock at a cost to it of \$5,025.00 less than its stockholders had theretofore paid for it. This was wholly a capital transaction."

This court has decided an analogous case contrary to the contentions of respondent. In *Commissioner of Internal Revenue v. Inland Finance Co.* (C.C.A. 9) 63 F.(2d) 886, the question before the court was whether a corporation realized a gain when payments on stock subscription contracts were forfeited for non-payment of installments. It was held that such payments did not constitute income to the corporation, the court saying:

"We are of opinion that the Board correctly determined that the forfeited payments did not constitute 'income' as the term has been defined; namely, gain derived from capital or labor or from both combined. *Eisner v. Macomber*, 252 U.S. 189, 207, 40 S. Ct. 189, 65 L. ed. 521."

The analogy between the foregoing case and the case at bar is strongly brought out in the opinion of the Board of Tax Appeals in a case dealing with forfeitures of stock subscriptions.

"The payments on account of the stock sub-

scriptions at the time they were made were undoubtedly capital payments, being made to provide capital for the corporation, and were in its hands capital receipts as distinguished from income. The fact that payments were made in installments and stock was never issued for such payments because they were not made to the full amount of the subscription does not alter their character."

Appeal of Illinois Rural Credit Association,
3 B.T.A. 1178.

See also to the same effect:

Industrial Loan & Investment Co., 17 B.T.A.
1328;

Realty Bond & Mortgage Co. v. U. S. (C. of
Claims) 17 F. Supp. 771.

When a payment on a stock subscription contract is forfeited, the corporation has additional funds against which it has no corresponding obligations. This court has said that such forfeited payments are not "gain" to the corporation, citing the definition of "gain" as laid down by the Supreme Court of the United States in *Eisner v. Macomber*, 252 U.S. 189, 40 S. Ct. 189, 64 L. ed. 521. If the payments on forfeited subscription contracts do not constitute a gain, it can hardly be said that the net discount on the repurchase of preferred shares constitutes a gain. In both cases, the receipt of the funds originally paid in on the transaction constitutes a capital transaction. No subsequent event can change the character of the payments to earnings or profits.

CONCLUSION

It is submitted that The Tax Court of the United States was in error in holding that the earnings or profits of Murphey were increased by the repurchase of its preferred shares at less than their par value.

Respectfully submitted,

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